IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

No. 10246.

SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF AMICUS CURIAE OF NATIONAL COUNCIL OF FARMER COOPERATIVES.

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BRIEF AMICUS CURIAE OF NATIONAL COUNCIL OF FARMER COOPERATIVES.

I.

APPLICATION FOR LEAVE TO FILE BRIEF AMICUS CURIAE.

Now appears The National Council of Farmer Cooperatives, having its principal office at 1731 Eye Street, N. W., Washington, D. C., acting through Eugene L. Hensel of Columbus, Ohio, its attorney, and respectfully requests leave of court to file a brief amicus curiae in this action.

Your applicant represents that it is an association with a direct membership of two hundred and thirty-five federated agricultural cooperatives, which, in turn, have members consisting, in the aggregate, of approximately forty-five hundred individual agricultural cooperative associations, serving approximately two million farmers located in all portions of the United States. The questions of fact and law involved in this pending action are of vital importance to the applicant and its constituent members, inasmuch as the marketing of farm products and purchase and distribution of farm supplies are, to a very large extent, conducted through the medium of farmer-owned agricultural associations. Hence, the issues before this court in this cause are of great public importance, and the decision of the court will have a widespread effect, not alone upon the business and affairs of the petitioner, but upon the hundreds of other agricultural cooperatives which are organized and transact their business in a manner similar to the petitioner.

Respectfully,

EUGENE L. HENSEL,
8 East Long Street, Columbus, Ohio,
Attorney for National Council of Farmer Cooperatives.

II.

STATEMENT OF FACTS.

(1) The petitioner is a bona fide agricultural cooperative association organized under the Agricultural Non Profit Cooperative Marketing Association Act of the state of California. It is organized on a membership basis, with a $10.00 membership fee. By the terms of Article II of its Articles of Incorporation, the petitioner is prohibited from paying any dividend or interest on membership certificates (R., p. 95). Membership is limited to bona fide producers of agricultural products. The petitioner is engaged in marketing poultry and eggs on behalf of its members and others, and in selling and furnishing farm supplies to its members and others. The volume of nonmember business of the petitioner was very small. With respect to its marketing transactions, in 1936 nonmember business represented 1.77% of the total business, and in 1937 it represented .11% of the total business (R., p. 78). Marketing of nonmember eggs was treated as cash purchases (R., p. 52). In purchasing supplies the volume of nonmember business in 1936 was 10.47% of the total business, and in 1937 it was .52% of the total business (R., p. 78).

(2) In marketing farm products and purchasing farm supplies, it was the practice of the petitioner to operate at cost, plus an estimated margin for expenses incurred in transacting business. At the end of each year the income and expense was calculated, and if it was found that there was an excess of income over expense, that excess of overcharge was distributed to patrons in propor-

tion to their patronage (R., p. 54). In the payment of patronage refunds, the petitioner observed an equality of treatment between member and nonmember patrons (R., p. 54 and R., p. 135). All of the patronage refunds due nonmember patrons were paid to them in cash, and were at a higher percent than those paid member patrons because only a portion of the refunds due member patrons was paid in cash, the remainder being credited to the member patrons in certain reserve accounts carried on the records of the petitioner. The difference between the actual cash refunds paid to nonmembers and members was represented by the interest of the member patrons in the reserve accounts and credited to each specific member.

(3) During the years 1936 and 1937, the following resolutions were adopted by the board of directors of the petitioner, to wit:

(a) Resolution adopted December 21, 1936, authorizing payment of patronage refunds for the year 1936 to members and nonmembers alike, and directing the employees of the petitioner to execute the terms of the resolution (R., p. 135).

(b) Resolution adopted December 31, 1936, authorizing the creation of a reserve account designated as "Reserve Against Loss by Overpayment" in the amount of $1,683.56, representing accumulation of retentions from proceeds of sale of members' eggs in the year 1936, and created to avoid the possibility of loss due to market fluctuations, deterioration, carrying charges and unexpected expenses (R., p. 136).

(c) Resolution adopted December 31, 1936, declaring patronage refunds for the year 1936 to members at the

rate of 2% on member purchases, and to nonmembers at the rate of 3½% on nonmember purchases, and reciting that the difference in the rate payable to members and nonmembers represented the amount carried to the reserves for the account of members. The resolution further authorized the payment in cash to members and nonmembers of the refunds so declared, the total amount being $14,214.93, of which $11,725.75 was payable to members and $2,489.18 was payable to nonmembers (R., p. 137).

(d) Resolution adopted December 31, 1936, authorizing the creation of a reserve designated as "Reserve for Zoning Hazard", in the amount of $5,722.72 (R., p. 138). This reserve was created against a contingency which might arise due to complaints from abutting property owners that the operation of petitioner's business constituted a nuisance and might result in the necessity of outlay in moving or altering its facilities (R., p. 23).

(e) Resolution adopted December 31, 1936, authorizing the transfer of the sum of $2,215.29, being 10% of the petitioner's net savings or overcharges for the year 1936, from the operating account to the "Reserve for Security of Membership", and directing that the interest of each member in this fund be pro rated and credited upon the records (R., p. 139).

(f) Resolution adopted December 31, 1937, affirming the proposition that the petitioner was organized and operating as a nonprofit cooperative association on a cost basis, plus expenses. It further recited that the individual members and patrons should be credited on the books of the petitioner with their pro rata share of any amounts retained by the petitioner which did not represent valuation reserves or current costs and ex-

penses for transacting business. It further directed the accounting officers to record credits due to members upon the books of the petitioner for the amounts allocable to each member. It further recited that the credits so allocated to each member patron should be paid as and when the board of directors should determine petitioner had available funds therefor (R., p. 140).

(g) Resolution adopted December 31, 1937, authorizing the transfer of the sum of $2,601.90, being 10% of the petitioner's net savings or overcharges for the year 1937, from the operating account to the "Reserve for Security of Membership", and directing that the interest of each member in this fund be pro rated and credited upon the records (R., p. 142).

(h) Resolution adopted December 31, 1937, declaring patronage refunds for the year 1937 to members at the rate of 2% on member purchases, and to nonmembers at the rate of 2.87% on nonmember purchases, and reciting that the difference in the rate payable to members and nonmembers represented the amount carried to the reserves for the account of members. The resolution further authorized the payment in cash to members and nonmembers of the refunds so declared, the total amount of refunds being $18,058.65, of which $17,924.32 was payable to members and $134.33 was payable to nonmembers (R., p. 143).

(i) Resolution adopted December 31, 1937, authorizing the transfer of the sum of $9,657.81 from the operating account to the "Reserve for Zoning Hazard" (R., p. 145).

(4) The books, records, ledgers, and accounts of the petitioner were so kept that the allocated interest of each member in the three reserves, to wit: "Reserve for Se-

curity of Membership", "Reserve for Zoning Hazard", and "Reserve Against Loss by Overpayment", was set forth in minute detail (R., pp. 148, 149). From time to time certificates were issued to the members indicating to them their respective interests in the aforesaid reserves. Whenever a reserve, which was used for working capital, reached adequate proportions, the board of directors authorized the disbursement of the retained amounts to the respective members. In the redemption of these certificates, the older certificates were first redeemed. This is known as the revolving fund plan, whereby upon the accumulation of new retentions an equal amount of older retentions are redeemed or retired, thus stabilizing at all times the amount in the reserve required for working capital (R., p. 75).

(5) The petitioner filed with the collector of internal revenue income tax returns for the years 1936 and 1937. The returns for neither year disclosed any net income subject to taxation. Upon audit and review of the returns, the commissioner of internal revenue disallowed as deductions from gross income for said years the amounts credited by the petitioner to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", and assessed a tax deficiency for said years in the amount of $4,308.49. Thereupon, the petitioner perfected an appeal to the Board of Tax Appeals, which affirmed the findings of the commissioner of internal revenue and entered judgment thereon. The petitioner now prosecutes a petition for review of the order and decision of the Board of Tax Appeals by this court.

III.

STATEMENT OF ISSUE.

Broadly speaking, the sole issue before this court is whether the commissioner of internal revenue erred in disallowing as deductions from gross income of the petitioner for the years 1936 and 1937 the amounts credited by the petitioner to the respective accounts of its individual members in the "Reserve Against Loss by Overpayment", the "Reserve for Security of Membership", and the "Reserve for Zoning Hazard", and whether the Board of Tax Appeals erred in affirming the findings of the commissioner of internal revenue.

From a close examination of the decision of the Board of Tax Appeals, it would appear that the issue was even more narrowly limited to the question as to whether further or additional corporate action was necessary to be taken, other than that shown by the record, in order to fix or create liability on the part of the petitioner to its members for their respective aliquot portions of the three reserve accounts.

To rephrase the issue, it appears that if, at the end of each fiscal year, there existed a fixed liability on the part of the petitioner to its members, for payment to them of their respective credited amounts in the reserves, then, and in that event, the amounts represented by said reserves were allowable deductions from gross income. But, if, on the other hand, there was no fixed corporate liability for payment by the petitioner to its members of the amounts represented by said reserves, such amounts would constitute income of the corporate entity, as such, as distinguished from its members, and would be disallowed as deductions from gross income for the years in question.

IV.

ARGUMENT IN SUPPORT OF CONTENTION THAT AMOUNTS CREDITED BY PETITIONER TO "RESERVE FOR SECURITY OF MEMBERSHIP", "RESERVE FOR ZONING HAZARD", AND "RESERVE AGAINST LOSS BY OVERPAYMENT", ARE DEDUCTIBLE FROM GROSS INCOME.

In this brief amicus curiae, we desire to concur in the position taken by the petitioner that the amounts credited during the years 1936 and 1937 to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", are deductible from gross income for purposes of computing and determining federal income tax. Our position is based upon two propositions:

(1) The amounts represented by these reserves never were income of the corporate entity, but at all times constituted property of the individual members, temporarily in the custody or possession of the petitioner, by reason of the method by which the petitioner and its members transacted business, and subject ultimately to be returned to the custody and possession of the individual members; and,

(2) If the amounts represented by these reserves are to be considered as included in gross income of the petitioner, on the theory that any moneys which it physically receives constitute gross income, then such amounts are deductible from gross income in arriving at the net income of the corporate entity because of the fact that

there is a fixed liability on the part of the petitioner to ultimately repay said funds to its members.

But, in either event, it is strongly urged that there is a fixed and definite liability on the part of the petitioner to its members for the amounts retained and credited to the reserves in question.

A. The Provisions of the Articles of Incorporation and the By-laws of the Petitioner Create a Liability on the Part of the Petitioner to Its Members For Payment of Amounts Credited to Reserve Accounts.

The rule that the articles of incorporation and the by-laws of an association constitute a contract with its members is too thoroughly established to require citation of authority.

In Article VI of the Articles of Incorporation of the petitioner (R., pp. 97, 98) it is provided that upon dissolution the assets of the petitioner shall be distributed in the following order of priority: (1) To the payment of general indebtedness as distinguished from amounts owing members; (2) Next, up to the face value of the Feed Finance Fund Certificates, if any, with interest; (3) Next, not to exceed the face value of the membership certificates; (4) And finally, the residue, if any, to the holders of the Feed Finance Fund Certificates and Advance Fund Certificates in proportion to the patronage of the holders of such certificates with the petitioner, limited to the period within which the certificates may have accumulated.

In paragraph 22 of Section 11 of the by-laws (R., p. 116), the board of directors is granted power, under certain circumstances, to levy assessments on members

and, upon the occurrence of certain acts of default, to sell membership certificates and to forfeit all right, title and interest of a delinquent member in the property and assets of the petitioner. But any such action **"shall not relieve the association under its obligation under any outstanding Advance Fund Certificates held by said delinquent member".**

In Article VIII of the by-laws (R., p. 124 et seq.), "net proceeds" are specifically defined to be such funds as are derived from overcharges on sales and as are left after all expenses have been paid or provided for. It is provided, further, that the "net proceeds" shall belong to the members and shall be pro rated to them in proportion to the amount of business each member has transacted with the petitioner.

The article further defines the various sub-funds and their inter-relation to each other. In this article provision is also made for partial payments of patronage refunds in cash and partial payments by crediting the remainder of the funds to reserve accounts. It also provides for retirement of certificates issued against reserve accounts in the order of their issuance on the revolving fund plan. In Section 8 of this article (R., p. 130), specific provision is made for the "Reserve for Security of Membership".

In Article IX of the by-laws (R., p. 132), the provision for disposition of assets upon liquidation or dissolution follows the outline set forth in Article VI of the Articles of Incorporation, supra.

As each new applicant is accepted for membership by the petitioner, there is transmitted to him, in addition to a copy of the by-laws, an explanatory letter (R., p. 146), definitely stating the manner in which the peti-

tioner operates; that retentions will be made from amounts due the member; and that part of the retentions will be refunded in cash and part credited to his account in reserves. He is further notified that the plan of operation provides for either immediate partial distribution in cash or a future distribution in cash, or its equivalent.

Under these circumstances a member, in dealing with the petitioner, has fully acquiesced in the procedure followed by the petitioner in transacting its business, including the partial retention of refunds due the members, with the understanding that while the same constitute the property of the members, they may not actually be disbursed to the members until some future date.

Thus, it will be seen that the contract between the petitioner and its members, consisting of the application for membership, the acceptance thereof, the articles of incorporation, and the by-laws, and affirmed by the transactions between the petitioner and its members, specifically provides that refunds accruing to the account of the member, but retained by the petitioner, are at all times the property of the member, subject only to being reduced to possession by him at such time as the board of directors may determine funds are available therefor.

Summarizing these facts, the liability of the petitioner to the members is definitely fixed and determined by contract, and any attempt by the petitioner to evade the liability so created would constitute a flagrant breach of the contract existing between the petitioner and its members.

The creation of liability on the part of a cooperative agricultural association to its members, by virtue of contract, is a matter neither new nor novel in the applica-

tion of the federal income tax laws. Recognition of this principle is found in adjudicated cases.

In **Farmers Union Cooperative Association v. Commissioner of Internal Revenue**, 13 B. T. A., 969, recognition was given to contractual liability of the association, created by the provisions of its by-laws.

In **Home Builders Shipping Association v. Commissioner of Internal Revenue**, 8 B. T. A., 903, the contractual liability arose out of oral agreements between representatives of the association and the stockholder members, whereby the stockholder members were induced to purchase stock in consideration of the future liability of the association to pay patronage refunds.

In **Anamosa Farmers Creamery Co. v. Commissioner of Internal Revenue**, 13 B. T. A., 907, the contractual liability of the association was fixed by virtue of the provisions of the by-laws.

In **Midland Cooperative Wholesale v. Commissioner of Internal Revenue**, 44 B. T. A., 824, contractual liability arising out of the provisions of the articles of incorporation and the by-laws of the association was recognized and affirmed by the Board of Tax Appeals.

B. Resolutions of the Board of Directors Constitute a Recognition, Affirmance, and Ratification of Liability on Part of Petitioner to Its Members For Payment of Amounts Credited to Reserve Accounts.

Based upon the facts hereinabove recited, and the authorities noted, we advance the proposition that the provisions of the articles of incorporation and the by-laws of the petitioner, creating liability on the part of the petitioner to its members for the amounts credited to

the members in the aforesaid reserves, were self-executing. In other words, the contractual liability of the petitioner was so definitely fixed that we doubt any further action on the part of the petitioner was necessary with respect thereto.

However, the board of directors of the petitioner, apparently actuated by the theory that the provisions of the articles of incorporation and the by-laws constituted a mandate to the board of directors to take action necessary to execute such provisions, passed a series of resolutions as shown by the record. The legal effect of these resolutions was to recognize, affirm, and ratify the liability of the petitioner to its members for the amounts standing to the credit of the members in the various reserves under consideration. Furthermore, the effect of the resolutions of the board of directors was to set in motion the machinery necessary to apportion and designate the specific liability as to each member.

Particular reference is made to the resolution adopted December 21, 1936 (Exhibit 3, R., p. 135), wherein the board of directors specifically gave recognition to the equality of treatment between member and nonmember patrons in the declaration and payment of patronage refunds.

The other resolutions are found in Exhibits 3, 4, 5, 6, 7, 8, 9, 10, and 11 (R., pp. 136-145).

Attention is directed to resolutions adopted December 31, 1936 (Exhibit 5, R., p. 137), and December 31, 1937 (Exhibit 10, R., p. 143), in which patronage refunds were declared for the years 1936 and 1937, respectively. In these two resolutions for the aforesaid years, the patronage refund rates were declared on member and nonmember business, and, in each instance, the rate of refund for

the member patron was less than the rate of refund for the nonmember patron. The reason recited in the resolutions for the differential in refund rates between members and nonmembers, was that the portion of the members' refund, necessary to equalize the rates, was carried to the reserves and credited to the members' accounts. Part of the patronage refunds declared by these two resolutions were paid in cash and part were credited to the members' accounts in the reserves (R., p. 88). It is significant that in the same action the board of directors, in each year, apportioned and set aside the interest of the member, whether the same was to be paid in cash or credited to his account, or both. But, regardless of the manner or method of payment of the refund, the quality and character of the refund was the same in either instance. Therefore, it logically follows that patronage refunds declared by these resolutions immediately became liabilities of the petitioner regardless of the time of payment. No distinction can be drawn between the quality or character of the liability—whether acknowledged by payment in cash, or a credit to the reserve accounts. Furthermore, notice of the refund action was sent to each member (R., p. 81). Thus the petitioner acknowledged to the member its indebtedness to him.

Supplementing the action of the board of directors in the declaration of patronage refunds, the auditors and accountants of the petitioner carried into execution the authorization, by making appropriate ledger account entries as to each patron (R., p. 71). Exhibit 13 (R., p. 148) is typical of the meticulous care with which such entries, showing both debits and credits, were made. The ledger entries constitute unequivocal evidence of rec-

ognition of liability to the members for their respective interests in all of the reserve funds under consideration. No account book could more accurately set forth the debtor and creditor relation than do these ledger accounts of which Exhibit 13 is typical.

C. The Retention by the Petitioner of Patronage Refunds, Due Members, and Credited to Their Respective Accounts in the Reserves, Constitutes the Borrowing of Money and is a Capital Transaction, and Not an Income Transaction.

The temporary retention by agricultural cooperative associations of amounts due their members is a practice peculiar to this particular type of corporation. In order to more fully comprehend the issues in this case, and to make proper application of legal principles to the facts, it is well not only to examine the form of procedure, but also to ascertain the substance of the practice. In other words, it is essential to ascertain what primary objective is sought to be accomplished by this practice. Once the true nature, or the substance of the practice, is ascertained, the legal relationship existing between the association and its members can be more readily determined.

In substance, the practice of partial retention, by an association, of amounts due its members constitutes the borrowing of money. The only purpose underlying the plan of retentions and deductions is to enable the association to obtain operating capital, and capital for the acquisition of facilities.

The universality of the practice followed by agricultural cooperative associations in obtaining operating

capital from its members is well established and recognized. The following are excerpts from the Law of Cooperative Marketing, by Evans and Stokdyk. At page 164 it is said:

> "As a means of securing subscriptions to capital, the membership fee is constantly declining in importance. This is for the reason that experience has shown that only nominal fees are satisfactory and that, after all, the most consistent and reliable source of revenue will arise from deductions or retains after the association is in operation."

Again, at page 174 of the same work, it is stated:

> "A common practice in dealing with membership contributions is to handle them in the form of revolving funds. This practice contemplates the repayment of the first contributions to capital when the desired amount of fixed and operating capital is obtained. It assumes, of course, that new contributions to capital will be made constantly."

In the ordinary business corporation, capital is acquired in various ways, the most common being the issuance of stock, debentures, bonds, certificates of indebtedness, or similar obligations. Generally, these securities are offered to the investing public. Both the issuing corporation and the investor in such securities are aware that the proceeds thereof will be used, either for operations, or for the acquisition of capital assets by the issuer. By law, there is created a liability on the part of the issuer to redeem such securities, according to the terms and tenor thereof, up to the extent that the assets of the issuing corporation are available for this purpose.

Funds realized by a corporation from the issuance of its securities have never been recognized as income for

taxation purposes, under the various federal income tax acts. Regulation 94 of the treasury department promulgated under the 1936 Revenue Act, in Article 22, (a)-1, contains the following statement:

> "In general, income is **gain** derived from capital, from labor, or from both combined, provided it be understood to include **profit**, gain through sale or conversion of capital assets." (Emphasis ours.)

See also Article 22, (a)-16, Regulation 94, in which the following statement is contained:

> "The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock."

See also Article 22, (a)-17, of Regulation 94, which contains the following:

> "If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amount so received being credited to its surplus account, or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as addition to and part of the operating capital of the company."

It is obvious that the petitioner, being a membership corporation, cannot obtain operating capital by the issuance of stock. We think it is equally obvious that the petitioner could not successfully issue bonds, debentures, or similar obligations for purchase by the invest-

ing public. Such investments would not be attractive to the general investor, who has no interest in, or knowledge of agricultural cooperatives. It necessarily follows that the petitioner, as well as similar agricultural cooperatives, must seek finances with which to conduct its operations from the class of persons most particularly calculated to be interested in the matter, to wit, its members. Loans, or advances, made to an agricultural cooperative association by its members, are not so made for the primary purpose of realizing a return on the investment, but for the purpose of enabling the association to provide an avenue whereby the members, as producers of agricultural products, may more effectively and economically market their farm products and purchase their farm supplies.

Consequently, the members of the petitioner, in becoming members, and in agreeing to be bound by the provisions of the articles of incorporation and the bylaws, have expressly agreed that, from time to time, they will make loans, or provide funds for the petitioner, necessary to afford adequate operating capital. To accomplish this purpose, it has been further agreed that, instead of the members making advances of cash, from time to time, the petitioner may retain funds of the members, in its possession, for operating capital. It is so expressly stated in their agreement. By its articles of incorporation (R., pp. 94, 95), the petitioner is expressly empowered to borrow money, to establish reserves, to levy assessments, and to use or employ any of its facilities for any purpose, and the proceeds arising from such use and employment shall go to reduce the costs of operation for its members. Retentions in the various reserve funds, and the liability to repay them

is recognized in Article VI of the articles of incorporation (R., p. 98). Specific authority for the retention of members' funds and the crediting of the same to reserves is detailed in the by-laws (R., pp. 113, 115, 125, 126, 127, 128, 129, 131).

If, at the end of each fiscal period, the petitioner had made a complete cash disbursement to its members as a repayment of these loans, there would be no question about the deductibility from gross income of such disbursements. If, immediately after such cash disbursements, or simultaneously therewith, the recipient member should tender back the moneys, as loans to the petitioner, the receipt of such advances by the petitioner would not constitute taxable income. The petitioner and its members have elected, as a matter of convenience, to omit this unnecessary detail. But, does the mere fact that these procedural details have been omitted in any respect change the character or the substance of the transaction? Scrutinized from any angle, and analyzed under all the circumstances, having in mind the ultimate purpose to be accomplished, we contend that the retention by the petitioner of the funds in the reserve accounts under consideration, constitutes the borrowing of money from its members, and that an absolute liability is imposed upon the petitioner to repay the same.

D. Creation of Liability Distinguished From Discharge of Liability.

It would appear that the error, upon the part of the Board of Tax Appeals, in applying the law to the facts in the case at bar, is the result of confusion, in failing

to distinguish the difference between the creation of a liability and the discharge of a liability, once created. The following excerpts are quoted from the findings of fact and opinion of the Board of Tax Appeals:

> "No amounts credited to this reserve, pursuant to petitioner's resolution summarized above, could be **paid** to any member or nonmember without authorization of the board of directors of the petitioner." (R., p. 26.)
>
> "The policy of the board of directors was to authorize **payment** to members whenever the financial condition of the petitioner was such that the amounts credited to the various reserve accounts could be **paid** to members without any detriment to petitioner. It was understood at all times that all moneys represented by the reserves, which were, in turn, credited to the various accounts of the members, could be used by the petitioner for any one of the purposes authorized in its by-laws. But if these amounts were to be used by the petitioner for **payment to members in cash or interest-bearing certificates** the **payment** had to be authorized by the board of directors of the petitioner." (R., p. 27.)
>
> "It is true that the petitioner credited to its patrons on its books an aliquot part of each of these reserves, but in each case further action of the board of directors was necessary before any portion of these reserves **could be made available to the members.** On the other hand, patronage dividends **in cash or certificates** could be distributed on authority of the resolution declaring them, without more." (R., p. 31.) (Emphasis ours.)

Upon reading the opinion as a whole, and particularly the excerpts quoted above, it becomes readily apparent that the Board of Tax Appeals was of the opinion that further corporate action was necessary to be taken by the petitioner, in order to **create liability** on the part of the petitioner to its members for the amounts credited to their accounts in the reserves. Herein lies the error.

It has been demonstrated that under the facts in the instant case, and the law applicable thereto, fixed, definite and certain liability was created against the petitioner through its articles of incorporation, by-laws, corporate resolutions, and contract with its members. It is conceded that further corporate action was necessary in order to authorize the **payment** of these liabilities to the members. The by-laws specifically provide that certificates of members' interest shall be retired, and payments of reserve funds shall be made to the members upon authorization of the board of directors (R., pp. 126, 128, 130, 131). Properly interpreted, this simply means that the **time of the discharge** of the liability shall be determined by the board of directors. The liability definitely **created**, as above indicated, is subject to **discharge** upon determination and authorization by the board of directors.

The maker of a promissory note **creates** liability when he executes the note; he **discharges** that liability when he pays the note. A debtor vendee **creates** liability, when he purchases goods from a creditor vendor; he **discharges** liability when he makes payment to the creditor. The character of the liability is in no manner altered by reason of the fact that the time of its discharge is subject to the determination of the debtor. There is nothing unusual about this. The discharge of a liability may be at a future time certain, or at a time determined by some future act.

Under the Federal Income Tax Law, the deduction of a liability from gross income is allowable if the liability is **created** during the taxable year. The fact that the liability, **created** within the taxable year, is **dis-**

charged subsequent to the taxable year, does not alter this rule.

> **Farmers Union Coop. Assn. v. Commissioner of Internal Revenue**, 13 B. T. A., 969;
> **Home Builders Shipping Assn. v. Commissioner of Internal Revenue**, 8 B. T. A., 903;
> **Anamosa Farmers Creamery Co. v. Commissioner of Internal Revenue**, 13 B. T. A., 907;
> **Midland Cooperative Wholesale v. Commissioner of Internal Revenue**, 44 B. T. A., 824.

G. C. M. 17895—C. B. 1937—1, p. 56, a portion of which is quoted as follows:

> "Patronage dividend may be excluded in determining the amount of undistributed net income subject to tax * * * provided the **liability therefor is set up on the books of the cooperative organization** pursuant to corporate action taken with respect thereto prior to the close of the particular accounting period." (Emphasis ours.)

E. Erroneous Application, by Board of Tax Appeals, of Authorities to Facts in Case at Bar.

In the opinion of the Board of Tax Appeals, in the instant case, its decision, sustaining the commissioner of internal revenue, is predicated upon several reported cases, cited in the opinion (R., pp. 29-31). A careful examination and analysis of the cited authorities clearly indicates an erroneous application of them to the facts in this case.

In **Fruit Growers Supply Co. v. Commissioner of Internal Revenue**, 21 B. T. A., 315; affirmed 56 Fed. (2d), 90 (CCA 9); patronage refunds accrued to the account of the patrons only when, and if, authorized by the board of directors. Under the terms of the by-laws, there could be no automatic accrual of refunds, nor could

individual credits be set up on the records to the account of the members. The Board of Tax Appeals properly held that under the circumstances corporate action by the board of directors was necessary before refunds were realizable or accrued. An analysis of this case develops the fact that declaration of refunds, as distinguished from the payment of the refunds, was the important element controlling the allowability of deductions of such sums from gross income.

In affirming the Board of Tax Appeals, the Circuit Court of Appeals, at page 93 of its opinion, say:

> "Until 'patronage dividends' are declared they have not accrued as obligations from the corporation to its members."

In **Farmers Union Co-op Co. v. Commissioner of Internal Revenue**, 90 Fed. (2d), 488 (CCA 8), there was no requirement, in the articles of incorporation or the by-laws, for automatic apportionment of surplus income to the credit of individual members. The petitioner sought to claim as allowable deductions from gross income, the net undistributed and unapportioned surplus earnings, on the general theory that its cooperative form of operation fixed title in the net surplus in the members, to the exclusion of the corporate entity.

At page 491 the court in its opinion, say:

> "This argument would acquire force and would require examination here if such were the situation of the petitioner. The reason why such argument is not here applicable is that the distribution of earnings was not required by the governing statutes, the articles of incorporation, or the by-laws to be confined to patrons. In fact, the statute permitted such earnings to be partly diverted to holders of shares of stock; * * *."

In **Cooperative Oil Association v. Commissioner of Internal Revenue**, 115 Fed. (2d), 666 (CCA 9), the articles of incorporation and by-laws contained a general provision for the distribution of net earnings to the stockholder patrons. The determination, however, of such refunds was subject to declaration by the board of directors, before liability of the petitioner was established. There was no automatic accrual to members of refunds. It was the practice of the directors only to declare the specific refunds actually paid to the members. The remainder of the savings was placed in an undistributed reserve account without any specific allocation of credits to members. The court held (at page 668), that the undistributed surplus or earnings which had not been declared as patronage refunds, or apportioned to the members, and for which no specific allocation was made to the members on its records, could not be allowed as a deduction from gross income.

The case of **Midland Cooperative Wholesale v. Commissioner of Internal Revenue**, 44 B. T. A., 824, strongly supports the position of the petitioner in the case at bar. In that case, under the provisions of the articles of incorporation and the by-laws, the directors declared patronage refunds, part of which were paid in cash, and part were placed in reserves. Both the portion of the refunds paid in cash and the portion held in reserve were allocated to the patrons at the same time, and entered upon the corporate ledgers as credits to individual members. Both were computed upon the business transacted with the association, and hence were accrued liabilities. It was held that no further, or additional, corporate action was necessary to create liability on the part of the petitioner to its members.

Not by the widest stretch of logic or reasoning can the rule announced in **Corliss v. Bowers**, 281 U. S., 376, be made applicable to the instant case. The rule therein was limited, strictly, to the taxability of income by the recipient or potential recipient thereof. Under the specific facts before the court, it was held that income of a revocable trust estate was taxable to the donor of said estate, even though the same was actually received by the beneficiary, because the donor had the right to receive the income, whether or not he actually saw fit to receive it. The Corliss case simply determined under what circumstances a recipient or a potential recipient of income, was subject to taxation thereon. In no respect does the court attempt to prescribe any rule applicable to the taxable status or liability of the payor of the moneys which were the subject of income by the recipient or potential recipient thereof.

V.

CONCLUSION.

From the record as a whole, it is apparent that the petitioner had no net income subject to federal income tax for the years 1936 and 1937. The funds credited to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", were not income of the corporate entity, but constituted loans, or operating funds, advanced to the petitioner by its members. By contract between the petitioner and its members, as evidenced by the corporate articles of incorporation and by-laws, and by corporate action as evidenced by the resolutions of its

board of directors, a definite legal liability was created on the part of the petitioner to its members for the amounts credited to the aforesaid reserves. The commissioner of internal revenue should, therefore, either have permitted the amount of said reserves to be excluded from gross income of the petitioner, or, if included, to be allowable as deductions from gross income for the years in question. We submit that the order and judgment of the Board of Tax Appeals should be reversed.

Respectfully submitted,

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